Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis

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FILLING GAPS IN THE CLOSE CORPORATION CONTRACT: A TRANSACTION COST ANALYSIS

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I. INTRODUCTION

Viewed contractually, the typical closely held corporation is mostly gaps. That is, the close corporation contract—the standard form rules provided by state corporation law as supplemented by a particular corporation's articles, by-laws, and shareholders' agreements—usually does not specify how an incorporated, closely held firm and its investors will substantively adapt to most future contingencies. As a result, these gaps must be filled *ex post*, as a need to adapt actually occurs.[1] Normally, gaps are filled by the shareholders themselves acting by consensus. If consensus is not possible, then the close corporation contract's gap-filling processes will come into play.

The close corporation contract assigns primary gap-filling authority to majority shareholders,[2] and gives secondary, discretionary gap-filling authority to courts. If complaining minority shareholders establish that the majority's conduct is oppressive, violates fiduciary duty, or is inconsistent with the minority's reasonable expectations or interests, then courts will generally grant equitable relief.[3] In so doing, it may be said that the court itself elects to fill a gap in the close corporation contract.

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1 Gap-filling problems are endemic to all relational contracts. For helpful analysis, see E. ALLAN FARNSWORTH, CONTRACTS § 7.15-7.17 (2d ed. 1990); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985) [hereinafter Goetz & Scott, *The Limits of Expanded Choice*]; Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

2 For example, the majority may discharge a minority shareholder from the corporation's employ. The majority also may establish or continue policies concerning payment of dividends, redemption of shares, or compensation of shareholder-employees that displease a minority shareholder. Additionally, the majority may dissolve the corporation or merge it into a corporation from which the minority is excluded.

3 *See* Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193 (1988).

However, litigation is costly and minority shareholders cannot be certain that they will prevail. Thus, the close corporation contract, as currently interpreted by most courts, leaves substantial room for majority shareholders to favor their own interests and ignore minority shareholders' concerns.

Academics are sharply divided concerning the fairness and efficiency of close corporation law's majority-favoring gap-filling rules. Much of the debate has centered on the implications of the partnership analogy and the "would have wanted" gap-filling theory. Under one prominent view, lawmakers should resolve or prevent postharmony[4] disputes in close corporations by referring to partnership law. This view has been most thoroughly developed by John Hetherington and Michael Dooley.[5] They argue that closely held corporations and partnerships are functionally equivalent entities having similar organizational needs[6] and that partnership law provides better governance rules for such closely held firms than does corporation law.[7] Hetherington and Dooley apparently believe that if bargaining impediments did not exist, minority investors would always insist on partnership form or partnership-like liquidity rules.[8] Accordingly, they propose that such rules be provided to close corporations via an immutable statutory rule requiring closely held corporations to redeem the shares of dissatisfied shareholders at the latter's option.[9]

Other commentators argue that applying partnership law to close corporations would be inefficient and inconsistent with the "would have wanted" gap-filling theory. This view has been propounded most forcefully by Frank Easterbrook and Daniel Fischel in their recent book[10] and in an earlier article.[11] Easterbrook and Fischel assert that, in filling gaps

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4 A closely held corporation is in its postharmony phase when the shareholders can no longer govern their relation by consensus.

5 John A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977).

6 *Id.* at 6, 50-59.

7 Hetherington and Dooley identify investment illiquidity as the root cause of postharmony exploitation, and contrast the plight of minority shareholders with the more favorable situation of minority partners. *Id.* at 3-4. They note that the dissolution provisions of partnership law give each partner the power to force a liquidation of the firm. *Id.* at 3. Liquidation, in turn, creates a market for the minority partner's interest so long as other partners or outsiders are willing to buy the partnership's assets.

8 *Id.* at 38. In Hetherington and Dooley's view, minority shareholders typically have limited knowledge and foresight concerning the risks of corporate form, tend to be excessively trusting of the majority, and are unwilling to raise questions at the outset of the venture that might demonstrate lack of confidence in the majority. *Id.* at 36-38.

9 *Id.* at 2-6.

10 FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 228-52 (1991).

11 Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986).

within the close corporation contract, courts must decide what the parties "would have bargained for had they anticipated the problems and been able to transact costlessly in advance."[12] According to Easterbrook and Fischel, absent transaction costs, rational majority shareholders would not always bargain for partnership-like rules.[13] Thus, courts should not seek guidance in their gap-filling efforts by analogizing close corporations to partnerships.[14]

I believe that proponents of each view are partially correct. Some investors who choose unmodified close corporation form would adopt modifications, sometimes modeled on partnership law, but for bargaining impediments. On the other hand, some investors in closely held firms do rationally choose and prefer unmodified corporate form. Needed, then, is a more refined theory of rational form selection and efficiency-minded judging[15] that better explains the relationship between partnership and corporation law and how courts should identify and fill gaps in the close corporation contract.

This Article develops a more refined transaction-cost based theory which explains: why rational investors in jointly owned, closely held firms initially choose corporate form; why they leave the contractual gaps that they do; and how efficiency-minded judges should respond to postharmony disputes made possible by the form chosen and the gaps left. My theory takes into account not only the possibility that investors should have chosen partnership law, but also the advantages and disadvantages of organizing production as an implicit team, via long-term contracts between separate businesses or as a sole proprietorship. In explicating this theory of form choice, the Article initially assumes that investors are fully rational. Later, I relax that assumption and consider how courts should respond to situations in which rational investors would not have selected corporate form.

Central to my theory is an understanding of the dichotomy between opportunism and adaptability. This Article shows that rational individuals choose to operate as a firm in response to a governance problem endemic to team production supported by team-specific investment—the

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12 EASTERBROOK & FISCHEL, *supra* note 10, at 34.

13 Instead, majority investors might insist on corporate form out of rational fear that minority shareholders would use unconditional withdrawal rights opportunistically to leverage unfair advantages. *Id.* at 241-42.

14 Proponents of the "would have wanted" gap-filling theory do not agree how courts should fill gaps in specific cases. Easterbrook and Fischel argue that courts should look to the contractual solutions commonly adopted by shareholders who do not leave a gap in their corporate contract. Easterbrook and Fischel argue that such actual contracts offer the best evidence of what the litigants would have done if they had bargained over the matter in dispute. *Id.* at 249-52. For other views, see authorities cited *supra* note 1.

15 "Efficiency-minded judges" are judges who make their decisions based on efficiency considerations. The first similar published usage of the modifier "efficiency-minded" of which I am aware occurs in Ayres & Gertner, *supra* note 1, at 94-95.

need to maximize individual and collective ability to adapt to changed circumstances, and at the same time, to minimize the ability of team members to obtain more than their fair share of team-specific value through opportunistic use of available adaptive mechanisms. Rational individuals, then, choose a governance structure for their firm that provides the optimal mix of adaptability and protection from opportunism.

Individual adaptability is maximized by rules allowing each owner to withdraw her capital at will. Collective adaptability is maximized by a governance structure that determines all adaptations, including the individual's right to withdraw capital, by majority rule. As individual adaptability is enhanced, so is the risk of minority opportunism. Conversely, as majority adaptability is increased, so is the risk of majority opportunism. Drawing on the dichotomy between opportunism and adaptability, the Article explains in detail: (1) when joint ownership is more desirable than a sole proprietorship; (2) why partnership form is optimal for jointly owned, closely held firms where fear of majority opportunism imposes greater *ex ante* costs than fear of minority opportunism; and (3) why corporate form is optimal when fear of minority opportunism predominates.

The Article builds on this theory of rational form selection to explain the gap-filling role of efficiency-minded courts. In so doing, I hope to shed light on the so-called contract analogy[16] and the "would have wanted" gap-filling theory.[17] I argue that an efficiency-minded court's

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[16] The view that corporations can meaningfully be analogized to contracts is central to the work of many scholars and has sparked substantial commentary. *See* EASTERBROOK & FISCHEL, *supra* note 10, at 1-39; Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99 (1989); John J. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988); Charles R. O'Kelley, Jr., *Opting In and Opting Out of Fiduciary Duties in Cooperative Ventures: Refining the So-Called Coasean Contract Theory*, 70 WASH. U. L.Q. 353 (1992); Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377 (1990). *See also* Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

[17] The "would have wanted" theory is often criticized as indeterminate. Critics point with delight to Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987) in which Judges Easterbrook and Posner, two leading proponents of the "would have wanted" theory, reached diametrically opposed gap-filling results. Indeed, not only do Hetherington and Dooley reach different conclusions than Easterbrook and Fischel, they also appear to be engaged in a search for the result that parties would have wanted if bargaining were costless. That formula is not explicitly used in their 1977 article, but is implicit in their explanation of why investors seek unmodified corporate form. *See supra* note 5, at 2-6.

More recently, Hetherington has explicitly acknowledged the primacy of this search:

> Bargaining is costly, and the parties may be expected to engage in it only when the prospective benefits exceed the costs. In resolving disputes ex post, the efficiency and productivity of exchange transactions would be enhanced if the courts sought the allocation which the parties would have made ex ante had they then considered that the gains of bargaining exceeded the costs.

John A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 20 (1987).

goal should be to assist investors in achieving an optimal *ex ante* balance between adaptability and opportunism. However, in pursuing this goal, the court must avoid a gap-filling approach that undermines the value-maximizing reasons that prompted shareholders to choose corporate form. Thus, the court must fashion a gap-filling rule that recognizes the relative concern for minority and majority opportunism indicated by both the form chosen and by the team members' investment characteristics.

II. A TRANSACTION COST EXPLANATION OF RATIONAL FORM SELECTION

A. Introductory Note

Rational individuals invest their human and money capital with a view to maximizing the value of such resources.[18] Thus, if rational individuals choose to become shareholder-employees of a closely held corporation, they do so in the rational belief that such choice will maximize the value of their human and money capital. This Part provides a transaction cost explanation[19] of when and why rational investors would so believe. In this Part, I ignore the distorting effect of tax and liability limitation rules and focus solely on the internal governance needs involved in form selection. These distorting effects are factored in later.[20]

The form selection theory is explicated by considering the organiza-

[18] A rational investor engages in an ongoing comparative search for the investment or investments that promise the most attractive return on invested capital given the investor's taste for risk. *See* CHARLES R. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 3-6 (1992); O'Kelley, *supra* note 16, at 354-55.

[19] Recognition of the importance of transaction costs is generally traced to Ronald H. Coase and his two seminal works: *The Nature of the Firm*, 4 ECONOMICA 386 (1937); *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960). Coase's insights have been recognized and extended in recent years in a variety of forums.

Frank Easterbrook and Daniel Fischel, whose recent book continues their contribution to Coasean scholarship, dedicate that book to Coase: "In particular, we like all other contemporary scholars in corporate organization owe a great debt to R. H. Coase, who first pointed out the similarity (and differences) between corporations and markets . . . . Without him the economic study of corporate law might lie ahead; to him we have dedicated this book." EASTERBROOK & FISCHEL, *supra* note 10, at viii.

Perhaps the most comprehensive and influential contribution to transaction-cost-economics scholarship is that of Oliver Williamson. *See particularly* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985) (dedicated to, among others, R. H. Coase). In turn, Williamson has been greatly influenced by the seminal works of Ian MacNeil concerning relational contract theory. *See* Ian R. MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978) [hereinafter MacNeil, *Contracts*]; Ian R. MacNeil, *The Many Futures of Contract* 47 S. CAL. L. REV. 691 (1974).

For other contributions to our understanding of Coase's insights, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J. L. & ECON. 1 (1983).

[20] *See infra* Parts IV.B, IV.C.2(b), and IV.C.2(c).

tional needs of two rational individuals—Suzanne and Emily—who have decided to join forces in a brewery venture. Suzanne, currently a sales representative for a national brewery, will be in charge of marketing and sales. Emily, now the head brewmistress at another brewery, will be responsible for beer production. Each will also make a money capital investment.

I will assume that at the outset of their venture Suzanne and Emily share two expectations: (1) that each of them will use her best efforts to make the venture successful; and (2) that profits will be divided according to each participant's relative contribution. To maximize the probability that these expectations will be fulfilled, Suzanne and Emily could structure their relationship as an implicit team, via a long-term contract, as a sole proprietorship, as a partnership, or as a corporation. The question, then, is which organizational structure promises to maximize the value of each investor's human and money capital.[21]

B. Transaction Cost Factors

In recent years, transaction cost economists have identified the behavioral and economic factors that explain why particular transactions are most efficiently organized in a particular way.[22] Academics in both law and economics are still working out the implications of this research. This Article applies the central transaction cost factors—bounded rationality, opportunism, and team-specific investment—in developing a theory of rational form selection.[23] For those unfamiliar with transaction-cost-economics terminology, a brief exegesis follows.

1. Bounded Rationality.—While individuals may intend to act rationally, there are cognitive limits, or bounds, on their ability to do so. Even if all relevant information is available, there are often too many variables to be considered. Understanding the limits on human rationality sheds light on the extent to which *ex ante* planning promises an efficient solution to future adaptive needs.[24]

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21 This Part involves a transaction cost analysis of team production in the closely held setting of the type suggested by Oliver Williamson:

> [O]rthodoxy holds that the allocation of economic activity as between firms and markets is a datum . . . . Transaction cost economics approaches the study of economic organization very differently. Thus firms, markets, and mixed modes are regarded as alternative means of organization, the allocation of economic activity among which is a decision variable. Firms, moreover, are described as governance structures, the internal organization of which has real economic consequences. An assessment of the contracting process runs the gamut from faceless transactions of the kind that are adequately serviced by auctioneers to complex bilateral trades in which the identity of the parties matters critically.

Oliver E. Williamson, *The Economics of Governance: Framework and Implications*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 195, 195 (1984).

22 *See supra* note 19.

23 For a comprehensive account and analysis of the interplay between and among these transaction cost factors, see WILLIAMSON, *supra* note 19, at 15-84.

24 "[B]ounded rationality recognizes that the problems with which human actors are attempting

2. *Opportunism.*—Economists assume that individuals will pursue their own self-interest in economic matters. However, there are two categories of self-interest seeking. First, in simple, or open, self-interest seeking, economic actors prefer their own interests to those of other economic actors, but do so while being honest and above board in their dealings. Second, opportunism is self-interest seeking with guile. Individuals who act opportunistically seek to further their own ends by taking advantage of the information deficits of those with whom they deal. Opportunistic actors seek to extract an advantage which would be denied them if the party with whom they deal had full information. As Oliver Williamson puts it, "opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse."[25]

3. *Team-Specific Investment.*—In pursuing their brewery venture, Suzanne and Emily may be described as a team, and their collective activities in making and selling beer may be described as team production. When an asset has a higher value in its current team use than in its next best use, the asset is said to have team-specific value—value that cannot be realized by putting the asset to another use.[26]

Suppose, for example, that Suzanne owns and operates a generic beer distributing business, and that Emily owns and operates a generic beer brewery. Suzanne buys generic beer for resale to grocery stores. She currently buys from Emily, but there are other brewers who would supply generic beer on similar terms. Likewise, Emily currently sells her product to Suzanne, but there are other distributors who would purchase her output on similar terms. If Suzanne and Emily stopped dealing with each other, thereby terminating their team, neither would experience any loss in the value of her human or money capital. Both Suzanne and Emily could earn the same return by dealing with others. Accordingly, neither Suzanne's nor Emily's investments are team-specific.

On the other hand, suppose that Suzanne is in the business of distributing only the special beer that Emily produces, and that there are no other suppliers who will give her an equivalent product on similar terms.

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to cope are very complicated in relation to their cognitive abilities." Williamson, *supra* note 21, at 198.

[25] *Id.* at 47.

[26] This insight belongs to both Williamson and Alchian. Armen A. Alchian and Susan Woodward in their excellent review-essay, *The Firm is Dead; Long Live the Firm: A Review of Oliver Williamson's The Economic Institutions of Capitalism*, 26 J. ECON. LITERATURE 65 (1988) (book review), put it this way:

> If a resource can leave a team without cost or loss of its value, Williamson would say it is independent or is not team-specific, or is "redeployable." But if the remaining resources would lose by its departure, they are dependent (*reliant* is the term in legal proceedings) on it, and to them, the departing resource is unique because they cannot replace it with no loss. Resources that are mutually dependent are also mutually unique, and vice versa.

Id. at 68.

Further, suppose that Emily only distributes her beer through Suzanne, and that there are no replacement distributors who would purchase the same volume or pay the same price as Suzanne. Under these circumstances, if Suzanne and Emily stopped dealing with each other, thereby terminating their team, each would experience a loss in the value of her human or money capital. Thus, Suzanne's and Emily's investments would be described as having team-specific value and as being mutually dependent.[27]

C. Organizing Production as an Implicit Team

If Suzanne and Emily need not make team-specific investments in order to carry out the brewery venture, then they can efficiently organize production as an implicit team.[28] Each can own a separate business—Suzanne's distributorship and Emily's brewery—and production can be carried out by Suzanne executing purchase orders for beer as she sees fit. Suzanne need not worry that Emily will opportunistically dilute the quality of her product or raise prices arbitrarily. Rather than submit to such price increases or continue buying beer from Emily after customer complaints, Suzanne could simply withdraw from her relationship with Emily and purchase adequate replacement beer from other suppliers. Suzanne's ability to costlessly withdraw from the team will likely prevent Emily from acting opportunistically. By the same token, Emily need not fear that Suzanne will arbitrarily demand a lower price for the beer she purchases from Emily, or that Suzanne will be lazy in her sales efforts, because Emily can find other equally acceptable outlets for her product.

On the other hand, the greater the team-specific investment made by Suzanne or Emily, the less satisfactory organizing as an implicit team will be. The existence of team-specific investment and the information asymmetries inherent in separate ownership and control combine to make opportunism possible. Opportunism arises principally because of the right of each team member to withdraw her capital without legal penalty. While such a right ensures that each team member will be able to adapt to changed circumstances, it also makes possible opportunistic threats of withdrawal.

For example, at some future date, Suzanne might opportunistically claim that factors beyond her control, such as competitive pressures, make it impossible for her to continue buying beer from Emily at the current price. She may threaten to switch suppliers and offer to continue buying beer from Emily only if she agrees to reduce her prices. Emily may not be able to ascertain whether Suzanne is acting opportunistically.

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27 *Id.*

28 There is a burgeoning body of literature on implicit contracts, which seems almost a contradiction in terms to lawyers. For a complete bibliography through 1985, see Sherwin Rosen, *Implicit Contracts: A Survey*, 23 J. ECON. LITERATURE 1144 (1985).

However, as long as the offered price is greater than Emily can obtain by switching distributors and at least enough to cover costs, Emily may reluctantly accede to Suzanne's demands and hope that Suzanne is both telling the truth and that her marketing situation will subsequently improve. As a result of Suzanne's opportunism, she will capture much of the team-specific value attributable to Emily's investment.[29]

Of course, Emily can also opportunistically claim that changed circumstances—perhaps the alleged availability of a new distribution network—require either a price change in her favor or a switch to a new distributor who will pay more. As long as the demanded price leaves Suzanne with more profit than she would obtain by changing beer suppliers, she might agree to the price hike and thereby shift a greater portion of the implicit team's value to Emily.

Even the risk of nonopportunistic withdrawal may lessen the attractiveness of organizing as an implicit team. For example, suppose that ten years after Suzanne begins selling Emily's beer, Emily correctly concludes that she will maximize the value of her investments by entering into an implicit and exclusive relationship with a new distributor—Sam. Suzanne will be required to shift her capital to other less valuable uses, and Emily will be under no legal obligation to compensate Suzanne for the capital loss occasioned by Emily's investment decision. It is important to note that Emily is not acting opportunistically in actually withdrawing. By operating as an implicit team, each team member has assumed the risk of loss from future contingencies that make it profitable for one party to withdraw from the team. Nonetheless, from an *ex ante* point of view, this all-or-nothing allocation of risk may be less than ideal for prospective investors who cannot diversify against such risks.

D. Long-Term Contracting

For individuals contemplating team-specific investment, operation as an implicit team may pose unacceptable opportunistic and nonopportunistic risks. These risks are made possible because any member may withdraw her capital from an implicit team without fear of legal penalty. One response to this problem is for team members to create an explicit team by negotiating and executing a long-term contract which specifies their rights and duties with respect to some or all contingencies. The availability of legal remedies should either party breach the contract may lessen the threat of opportunistic withdrawal and provide some sharing of the expected losses from nonopportunistic withdrawal.[30] On the

[29] This example draws on the discussion of appropriable quasi-rents in Benjamin Klein, et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. LAW & ECON. 297 (1978).

[30] Suppose that after commencement of the brewery venture, Sharon finds that her capital will have a higher value if redeployed in a new venture from which Jake will be excluded. If the venture is organized as an implicit team, then Sharon may simply withdraw and capture all of the gain from

other hand, while contractual specification of rights and duties may provide protection against opportunistic withdrawal, the parties may also incur significant costs from lost flexibility.[31] Thus, the utility of long-term contracting and the appropriate contracting strategy depend on the team's relative needs for adaptability and protection from opportunism.

Suppose, for example, that Suzanne and Emily attempt to negotiate a fully contingent long-term contract. They agree that Emily will provide 100,000 cases of beer annually for ten years at $3 per case, with an automatic cost-of-living adjustment every two years. Compared to operation as an implicit team, this fully contingent contract will significantly deter opportunistic threats of withdrawal. For instance, one year later Emily might demand a price increase, opportunistically claiming that she can now sell her beer at a much higher price and in much greater volume if she deals with other distributors. The availability of damages or other legal remedies will enable Suzanne to negotiate from a much stronger position than if Emily could withdraw from the team without legal penalty. Indeed, Suzanne may choose to simply refuse to renegotiate, secure in the knowledge that damages will be available if Emily breaches.

Suppose, however, that Emily's request is not opportunistic, that Suzanne refuses to renegotiate, and that the threat of legal penalty forces Emily to honor the contract, although it is no longer profitable.[32] If we assume that Suzanne and Emily intended the cost-of-living escalator clause to accurately cover Emily's future cost increases, then Emily's *ex post* loss results from the parties' contractual misspecification of how to adapt to changed circumstances.[33] Further, from an *ex ante* perspective we can assume that Suzanne and Emily realized that, despite their best efforts, their contract might contain terms that would later prove maladaptive. Accordingly, we can assume that, to the extent Suzanne and

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the changed circumstances that have made her capital more valuable in another use, and at the same time avoid bearing any of the loss in the value of Jake's capital caused by Sharon's withdrawal. If the venture is organized via a long-term contract, Sharon may withdraw but she will be required to compensate Jake for his contractual expectations. The obligation to pay damages could be viewed, then, as requiring Sharon to share with Jake the risk of loss resulting from subsequent nonopportunistic withdrawal by either of them. If, after fully compensating Jake, Sharon would still find it profitable to breach the contract, then such breach would be efficient. On risk sharing through contract, see A. Mitchell Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427 (1983). On the utility of efficient breach analysis, see Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1 (1989); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Ian R. MacNeil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).

31 On the inherent conflict between the need for specificity and the need for flexibility, see MacNeil, *Contracts*, *supra* note 19.

32 In this circumstance breach would not be efficient. *See supra* note 30.

33 For an excellent analysis of such "formulation errors," see Goetz & Scott, *The Limits of Expanded Choice*, *supra* note 1.

Emily were risk averse and unable to diversify against the risk of loss from misspecification, each of them would have discounted the value of their prospective investment to reflect such risk.[34]

The implications of this line of analysis may be summarized as follows. Prospective venturers may eliminate the risk of loss from misspecification by operating as an implicit team, but this exposes team members to the risk of loss from opportunistic threats to withdraw from the team. Alternatively, prospective venturers may reduce the risk of loss from opportunistic threats to withdraw from the team by attempting to negotiate a fully contingent long-term contract, but this exposes team members to a risk of loss from misspecification. Thus, rational investors will organize as an implicit team only if, viewed *ex ante*, the risk of loss from misspecification inherent in long-term contracting imposes a higher cost than the risk of loss from opportunistic threats to withdraw from the team.

An alternative to a fully contingent long-term contract is a contract that does not attempt to provide an answer to all contingencies at the time the relation begins, but instead provides a mechanism whereby such contingencies may be addressed in the future. For example, a long-term contract might provide that price or other terms will be arbitrated or renegotiated in good faith at either party's request. Such cooperative-adjustment devices signal to an efficiency-minded arbiter or court that the parties intended to minimize the risk of loss from misspecification.[35]

In comparison to a fully contingent contract, a contract with cooperative-adjustment clauses exposes the parties to a greater risk of loss from opportunistic requests for renegotiation, but to a lesser risk of loss from misspecification. However, in comparison to operation as an implicit team, a contract with cooperative-adjustment clauses exposes parties to a greater risk of opportunistic refusal to renegotiate (since gap-filling mechanisms do not costlessly or inevitably produce changed terms), but to a lesser risk of loss from opportunistic threats to withdraw (since neither party can simply withdraw without risk of legal penalty).[36]

E. Organization as a Firm

1. Introductory Note.—Implicit teams and teams organized via long-term contracts present a variety of responses to the opportunism/

[34] The reduction in value would be a type of "error cost" causing some affected individuals to simply forego a prospective venture. Others will invest but later bear the cost from "unintended resort to state interpretations of disputed contracts." *Id.* at 265.

[35] For examples and discussion of cooperative-adjustment clauses typically found in long-term contracts, see Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005, 2020-21 (1987). *See also* WILLIAMSON, *supra* note 19, at 178 (discussing role of specialized governance structures in promoting harmonious adaptation to changed circumstances).

[36] For a discussion of the advantages and limits of legal enforcement of cooperative adjustment clauses, see Scott, *supra* note 35, at 2042-46.

adaptability dichotomy. However, such teams are similar in one critical respect: Team members each retain legally separate ownership and control of a portion of the team's business assets. For example, whether organized as an implicit team or through long-term contracts, Emily will own or control the assets used in brewing beer and Suzanne will own or control the assets used in her distributorship. Because of this separate ownership, either Emily or Suzanne can make a credible threat to withdraw both her human and other capital from the team.[37]

The firm differs from both the implicit team and the long-term contract in that members of teams organized as a firm do not separately own identifiable parts of the team's business. This unification of ownership lessens the risk that one team member will threaten to withdraw from the team and take with her a portion of the team's business assets.[38] However, operation as a firm creates a need for governance rules to determine how control over the unified firm's assets will be allocated, and how the rights of individual team members will be balanced against the collective rights of the firm. These needs are usually satisfied by choosing to operate the firm as either a sole proprietorship, general partnership, or closely held corporation. The remainder of this subpart examines the governance reasons that motivate rational investors to select one or the other of these forms.

2. *Organization as a Sole Proprietorship.*—The simplest alternative to organization via implicit or explicit contracts between autonomous team members is a sole proprietorship. In a sole proprietorship one individual, the proprietor, owns and controls all of the physical capital needed to carry out team production and provide services to the firm. Under common-law rules, the sole proprietorship is created by the mutual assent of proprietor and agent, and either party may terminate the relationship at will. During this relationship, agency law imposes on the agent both a general fiduciary duty of loyalty to the proprietor and an obligation to obey the proprietor's commands concerning the agent's performance of her assigned tasks. No corresponding duty is imposed on the proprietor.[39]

The proprietor's right to control the agent's performance or to discharge her from the team's employ at will means that the proprietor is able to adapt to changed circumstances nearly as readily as if the team were organized as an implicit team.[40] Thus, a proprietorship governed

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[37] To make a credible threat of withdrawal from an implicit team, a team member must opportunistically allege plausible but untrue facts supporting the need for either changed terms or withdrawal from the team. To make a credible threat of withdrawal from a long-term contract, a team member must additionally make a plausible allegation that the gains from withdrawal will exceed the damages which would flow from breach if no agreement can be reached.

[38] *See* WILLIAMSON, *supra* note 19, at 78.

[39] *See* O'KELLEY & THOMPSON, *supra* note 18, at 12-41.

[40] The proprietor's discretion may be limited by the obligation of good faith and fair dealing said

only by common-law rules is not subject to the misspecification costs that attend organization via long-term contract.[41] Additionally, because all team-specific physical capital is owned or controlled by the proprietor and because the agent is constrained by fiduciary duties, the proprietor is subject to much less risk that the agent will opportunistically threaten to withdraw from the team than would be the case in an implicit team. However, operation as a sole proprietorship may expose the agent to a greater risk of opportunism than would organization via implicit or explicit contracts between autonomous producers.

Suppose, for example, that Suzanne and Emily organize their brewery venture with Emily as proprietor and Suzanne as agent. Emily owns or leases all of the buildings, machinery, equipment, furnishings, and other physical capital needed by the venture and spends most of her time supervising the brewery operations. Suzanne serves as a salaried, at-will employee and is responsible for sales. At some later date, Suzanne demands a substantial salary increase claiming that her contributions are not being fairly rewarded and that she will start a competitor firm if her demands are not met. As a sole proprietor, Emily is in a much stronger position to resist a demand that she suspects is opportunistic than she would be if the venture was organized as an implicit or explicit team between autonomous producers. Suzanne cannot take with her any portion of the team's physical capital. Additionally, fiduciary duty will prevent Suzanne from competing with Emily's proprietorship until after she has left Emily's employ.[42]

On the other hand, suppose that after a network of distributors is established, Emily informs Suzanne that production cost increases will make it necessary to either cut Suzanne's salary by forty percent or discharge her from the firm. Emily's actions may be an objectively justified response to changed circumstances or they may be an opportunistic attempt to steal most of the current or sunk value of Suzanne's team-specific human capital value.[43] In either case, Suzanne will likely accede to the salary cut if her human capital has less value in an alternative use, particularly if she believes that Emily is not being opportunistic.

3. *Choice of Joint Ownership Instead of Sole Proprietorship.*—A sole proprietorship will typically be chosen as the team's organizational form when one team member, the owner, has substantially more team-

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to exist in all contracts. Additionally, the proprietor may not discharge an employee when such discharge would violate public policy. For an excellent discussion of these limitations on the employment-at-will doctrine, see Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988). *See also* Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947 (1984); Mayer G. Freed & Daniel D. Polsby, *Just Cause for Termination Rules and Economic Efficiency*, 38 EMORY L.J. 1097 (1989).

41 *See supra* notes 30-34 and accompanying text.

42 *See, e.g.*, Community Counselling Serv., Inc. v. Reilly, 317 F.2d 239 (4th Cir. 1963).

43 *See* EASTERBROOK & FISCHEL, *supra* note 10, at 97-98.

specific capital at risk than other team members and therefore has the most to gain or lose from the success or failure of the team.[44] Residual claimant status motivates the owner to use her best efforts on behalf of the firm in her role as team monitor. In this role, she directs team members' actions, measures and compensates team members for their marginal productivity, and hires and fires team members as necessary. The proprietor's unilateral management power allows quick adaptation to changed circumstances, but exposes lesser team members to opportunistic action by the residual claimant. If the team-specific investment by the residual claimant is substantial and that of other team members relatively small, then the sole proprietor will generally have more to gain by making objectively justifiable adaptations that increase the long-term value of her residual claim, than by seeking short-term gain through "theft" of a portion of lesser team members' capital.[45] However, as the team-specific investment by team members increases, it both becomes excessively costly for one of them to efficiently monitor the team, and the risk of opportunism by a sole monitor becomes too great for other team members to comfortably bear.[46]

Joint ownership of a closely held firm typically arises, then, when team-specific skills and investment are distributed somewhat equally among team members. In such circumstances, mutual self-monitoring is more efficient than having one member attempt to learn enough to monitor other members.[47]

Whether organized as a general partnership or a closely held corporation, joint owners are constrained to some extent by fiduciary duties. As a result, joint ownership lessens the risk of opportunistic use of ownership rights that is ever present in a sole proprietorship.

Joint ownership also responds to the risk of opportunistic withdrawal threats that is always present in teams organized outside of a firm via either implicit or long-term contracts. Inherently, joint ownership ensures greater sharing of information about the parties' individual and collective needs. Joint ownership also makes it more difficult to untangle the physical capital contributions of the parties than would be the case if each party maintained separate ownership and control over discrete parts of the joint endeavor's physical capital. For both of these reasons, it becomes more difficult for a team member to maintain a credible threat of

44 A sole proprietorship involving mutual, team-specific investment is characterized by cooperative specialization by labor inputs (team members), one of whom serves as team monitor and is the firm's residual claimant. *See* Armen A. Alchian, *Specificity, Specialization, and Coalitions*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 34, 35-36 (discussing the nature of a team).

45 The obvious risk in seeking short-term gain through opportunism disguised as needed adaptation is that, if found out, the other team members may retaliate, resulting in an overall loss in value to the residual claimant.

46 *See* EASTERBROOK & FISCHEL, *supra* note 10, at 97-98.

47 On the importance of knowledge acquisition costs in explaining choice of organizational form, see Harold Demsetz, *The Theory of the Firm Revisited*, 4 J. L. ECON. & ORGANIZATION 141 (1988).

withdrawal based on unfounded adaptive needs. Nonetheless, though muted, the threat of opportunism will still exist to the extent joint owners retain withdrawal rights or are granted fiduciary protection under the relationship's governing rules.

III. A THEORY OF PARTNERSHIP FORM

A. Partnership Law's Statutory Governance Rule and the Archetypical General Partnership

Jointly owned firms range in complexity from a simple two-owner firm with relatively small team-specific value, to publicly held firms with thousands of investors and an enormous amount of team-specific capital.[48] The statutory governance rules of general partnership law can be best understood as ideally suited for jointly owned, closely held firms that are close to the margin where organization through simple contracts or within a sole proprietorship would be equally efficient.[49] As jointly owned firms move further away from the margin between organization via contract or sole proprietorship, and closer toward the publicly held firm, the partnership law governance rules become less optimal.

In an archetypical general partnership that is functionally near the margin where organization via contract or sole proprietorship would be equally efficient, each joint owner will expect to make similar team-specific human capital contributions. These rational investors do not seek a fixed specification of rights and duties because they anticipate a general need to adapt to future contingencies. On the other hand, they wish to see their adaptive rights constrained in a way that will optimally reduce the risk of opportunism. Consistent with these expectations, partnership law default rules provide that each partner will share equally in profits and losses,[50] and have equal rights in management and conduct of the partnership's business.[51] This initial assignment of rights recognizes the

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48 For a discussion of organizational form in terms of a spectrum or continuum ranging from simple market transactions to complex hierarchical organizations, see WILLIAMSON, *supra* note 19, at 83-84.

49 A partnership may be created without a written agreement and without any partner having actually intended to adopt partnership form. All that is required is that two or more individuals agree, implicitly or explicitly, to carry on as co-owners a business for a profit. UNIF. PARTNERSHIP ACT § 6, 6 U.L.A. 22 (1969). Presumably, partnership law provides a governance structure that is optimal for simple business associations formed with relatively little *ex ante* planning. The trigger point chosen for identifying teams that will be required, unless otherwise agreed, to use the partnership structure—the investors' decision to associate as co-owners in the conduct of a business for profit—is consistent with the analysis to this point. Crossing over from market or contractual organization of team production carries with it certain needs to adapt and concerns about opportunism. The interests of society, as well as efficiency-minded investors, are served by providing a satisfactory off-the-rack governance structure for these firms that might otherwise make team-specific investment as joint owners without creating an adequate governance structure.

50 UNIF. PARTNERSHIP ACT § 18(a), 6 U.L.A. 213 (1969).

51 *Id.* § 18(e), 6 U.L.A. at 213.

typical partners' assumed expectation of equal contribution. Additionally, status quo-protecting decisionmaking rules provide significant protection against opportunism. For example, major changes in the team's rules, such as modification of a partner's profit sharing, decisionmaking, or participation rights, cannot be made within the existing partnership except by unanimous consent of all partners.[52] In addition, new partners cannot be admitted without unanimous consent.[53] However, the initial assignment of rights and the constraints on less-than-unanimous action are partially counterbalanced by the ability of any dissatisfied partner, or group of partners, to unilaterally dissolve the partnership.[54]

The at-will dissolution mechanism protects both individual and collective adaptive needs. For example, if because of changed circumstances, a partner's capital will have a higher value when invested in some other endeavor, she may simply dissolve the old partnership and reinvest her human and money capital elsewhere. Moreover, this unilateral withdrawal mechanism may be used by the majority to achieve needed team changes that, absent unanimous consent, cannot be directly accomplished within the existing partnership. Thus, if a partner's human capital has become obsolete, but the partner will not retire, the majority may simply dissolve the old partnership, purchase the firm's assets at a judicial sale, and form a new partnership that does not include the former partner. On the other hand, the dissolution process is not without cost and uncertainty, both of which operate to constrain good-faith adaptive acts, unless they are clearly necessary.[55]

B. *The Problem of Opportunistic Use of the Partnership Adaptive Mechanism*

The partnership dissolution mechanism does not create the same risk of opportunism as is present in team production organized as an implicit team or via long-term contract. Partnership law guarantees each partner full information about partnership affairs,[56] and prevents a partner from simply withdrawing *in kind* her share of the firm's productive

52 *Id.* § 18(h), 6 U.L.A. at 213.

53 *Id.* § 18(g), 6 U.L.A. at 213.

54 *Id.* §§ 31, 38, 6 U.L.A. at 376, 456.

55 There have been recent suggestions to change the partnership dissolution rules, principally to give them more of the entity characteristics of corporate law. *See* Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987); UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121 (1987). In 1987, the National Conference of Commissioners on Uniform State Laws undertook a revision of the UPA. It remains unclear whether the Conference will propose fundamental changes in the longstanding rules of general partnership law. *See* Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 BUS. LAW. 427 (1991).

56 UNIF. PARTNERSHIP ACT § 20, 6 U.L.A. 256 (1969).

assets.[57] Instead, the ownership of these assets must be untangled by negotiation or judicial sale. Easy access to information about partnership business affairs and the cost involved in untangling ownership of partnership assets combine to reduce the likelihood that any partner will be able to make credible threats of withdrawal founded on claims that objectively unnecessary adaptations are, in fact, necessary.[58]

On the other hand, the at-will dissolution mechanism makes possible a new type of opportunism when the partnership has a significant amount of team-specific, nonhuman capital value. This opportunism takes the form of majority or minority action designed to "steal" a portion of the team-specific value belonging to other partners.[59]

Majority[60] opportunistic use of the at-will dissolution mechanism requires expulsion of the minority from the team at a cost to the majority that is less than the resulting increase in value of their ownership interest in the team. The majority would hope to proceed as follows: (1) Dissolve the partnership; (2) force a judicial sale of the partnership's assets; (3) form a new firm in which only the majority has ownership interests; and (4) acting as the new firm, purchase the partnership's assets for a bargain price at the judicial sale.

The majority's bargain purchase opportunity is a function of the team-specific value of the firm's human capital, the team-specific value of its nonhuman capital, the majority's share of the latter, and the majority's risk preferences and investment capacity. If the partnership's nonhuman capital has significant value, then existing partners should be able to outbid any outsider for the partnership's saleable assets.[61] The outsider will have greater cost, including increased exposure to risk, in creating a new team than will a subgroup of continuing partners, who must replace a lesser number of the old team. If the majority group has a

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[57] In rare exceptions, courts may refuse to order a judicial sale and instead, award the partnership's operating assets to the more deserving partner and only cash to the less deserving partner. *See, e.g.*, Nicholes v. Hunt, 541 P.2d 820 (Or. 1975).

[58] Of course, the possibility of opportunism is not eliminated. *See* Robert W. Hillman, *Law Firms and Their Partners: The Law and Ethics of Grabbing and Leaving*, 67 TEX. L. REV. 1, 31-50 (1988); Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 439-40 (1987). Nonetheless opportunism is *relatively* constrained.

[59] For a discussion of the costs that the at-will dissolution mechanism enables minority partners to impose on majority partners, see EASTERBROOK & FISCHEL, *supra* note 10, at 241-43.

[60] The term "majority" connotes a partner or group of partners that has a larger current team-specific investment than other partners. For example, if *A* and *B* are equal partners, but *B* has "loaned" the partnership substantial sums, then *B* is the "majority" partner, even though their profit and control rights are equal.

[61] Part of a team's value is the premium for creating a successful team. Both outside bidders and minority partners may have difficulty capturing any part of that premium. If the outside bidder attempts to employ or associate with members of the old team in order not to lose their team-specific value, she will incur substantial negotiating and execution costs. In addition, the majority group will obviously not contract with the minority. For a discussion of the importance of team-creation value, see Alchian & Woodward, *supra* note 26, at 70.

greater share of the partnership's team-specific human capital value than does the minority group that it seeks to exclude, then the majority group will likewise be able to bid more for the partnership's assets than will the minority, because of the majority's expected lesser cost in replacing team members. Additionally, if the majority group either has a greater ability to diversify its portfolio against the risks involved in taking on a larger share of the partnership's team-specific nonhuman capital, or a lesser aversion to risk, then the majority group will value the partnership's nonhuman capital assets more highly than will the minority.[62]

The opportunistic possibilities presented to a minority partner by the at-will dissolution mechanism arise not from actual use by the minority partner of this adaptive device, but instead from the majority's unwillingness to assume greater investment risk. We assume that rational investors are risk averse. Because general partners have limited wealth and are personally liable for all partnership debts,[63] it is unlikely that most partners will be able to achieve a diversified investment portfolio. Therefore, a rational general partner will usually seek to avoid any increase in the portion of her assets invested in team-specific assets, as well as any decrease in the portion of a fellow partner's wealth that is part of the joint pool that may be drawn on to pay partnership losses. Both of these undesired changes occur when a minority partner withdraws from the firm.[64]

Given the majority's natural reluctance to assume greater investment risk, a minority partner may act opportunistically in a variety of ways. For example, she may threaten to withdraw from the partnership, thereby dissolving it, unless the majority agrees to an alteration of the partnership rules to satisfy the minority's adaptive demands. Alternatively, she may shirk in the performance of her partnership duties. In either case, the minority acts opportunistically in the belief that the majority will tolerate her opportunism rather than risk precipitating dissolution of the partnership.

C. Contractual and Judicial Gap-Filling Responses to Opportunism Made Possible by the Partnership Adaptive Mechanism

Partnership law provides standard form rules that invite contractual and judicial gap-filling to lessen the opportunistic risks presented by the

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62 In part, the majority's bidding advantage may relate to defects in the judicial sale mechanism. *See* Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 317-18.

63 UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1969). If the risks of loss are not unlimited and can be predicted with reasonable certainty and if the partner's wealth is sufficiently great, then the partner's nonhuman capital portfolio can be diversified.

64 Withdrawal dissolves the firm, forcing partners who desire to continue the partnership's business, to buy its assets and pay off the withdrawing partner. *See id.* §§ 31, 38, 6 U.L.A. at 376, 456.

at-will dissolution mechanism.[65] The most important of these are the rules defining wrongful dissolution and its consequences.

Partnership law provides each partner an immutable right to dissolve her partnership by simple exercise of will.[66] However, if dissolution is caused "in contravention of the partnership agreement," then dissolution has been caused wrongfully, and the party causing such wrongful dissolution loses much of her bargaining leverage and is subject to certain penalties. The wrongful dissolver forfeits her right to force a liquidating sale of the partnership's assets,[67] and is liable to other partners for damages resulting from her wrongful act.[68] Further, the nonwrongfully acting partners have an option to continue the partnership's business without the wrongful dissolver's consent or participation.[69] If they exercise that option, the value of the wrongful dissolver's partnership interest will be determined without considering the goodwill of the partnership's business. The continuing partners may then either pay the wrongful dissolver, in cash, the net value of her partnership interest after damages, or secure the deferred payment of that sum under a court-approved bond.[70]

Partners may substantially reduce the risk of certain types of opportunism by simple contractual provisions linked to the wrongful dissolution framework. For example, the risk of opportunistic dissolution by the majority and opportunistic threats of dissolution by the minority may be greatly reduced by a simple agreement among the partners that the partnership will endure for a specified term or undertaking. Any dissolution of the partnership before completion of the agreed undertaking or term would be in contravention of the partnership agreement, and therefore, an act causing wrongful dissolution.[71]

On the other hand, if the partners' greatest concern is potential shirking by minority partners, the risk of this type of opportunism may be reduced by a contractual agreement among the partners providing that the majority may expel a partner under specified conditions. If a partner is expelled pursuant to such contractual power, then dissolution will not be considered wrongful.[72] The expelling partners may continue

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65 Scholars continue to disagree as to when a gap may be said to exist in the partnership or corporate "contract". In my view, these contracts are mostly gaps (*see supra* note 1 and accompanying text), but the parties have indicated their general gap-filling preferences by the form selected. *See* O'Kelley, *supra* note 16.

66 UNIF. PARTNERSHIP ACT § 31(2), 6 U.L.A. 376 (1969). There is substantial disagreement over the role and efficiency of immutable rights. *See* Ayres & Gertner, *supra* note 1.

67 UNIF. PARTNERSHIP ACT § 38(1), 6 U.L.A. 456 (1969).

68 *Id.* § 38(2)(a)(II), 6 U.L.A. at 456.

69 *Id.* § 38(2)(b), 6 U.L.A. at 456.

70 *Id.* § 38(2)(c)(II), 6 U.L.A. at 456.

71 Of course, this increased protection comes at the cost of lost adaptability and increased risk of opportunistic refusal to agree to objectively justified adaptation requests. *See supra* text accompanying notes 35-38.

72 UNIF. PARTNERSHIP ACT §§ 31(1)(a), 31(2), 6 U.L.A. 376 (1969). Although some authorities disagree (*see* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PART-

the partnership's business, and need only pay to the expelled partner the "net amount due her from the partnership."[73]

Unlike the rules applied to wrongful dissolvers, the expulsion-via-agreement rules impose no liability on the expelled partner for damages flowing from her shirking, and no penalty in the form of forfeiture of her share of partnership goodwill.[74] Thus, in order to make less likely opportunistic shirking founded on the majority's aversion to taking on greater portfolio risk, the contract creating a right of expulsion must also ensure that the amount due to an expelled partner will be less than the share to which she would be entitled in a nonwrongful dissolution of the partnership. The need to specify the conditions giving rise to a right of expulsion, and the payoff consequences of being so expelled, would likely involve substantial disagreement and accompanying transactions costs.[75]

If partners do not contractually provide a term or undertaking, or a right to expel the minority, efficiency-minded courts use fiduciary duty or other gap-filling techniques to minimize the risk of opportunistic action otherwise made possible by the at-will dissolution mechanism. The nature of the opportunistic risk determines the device selected.

Page v. Page[76] is the classic example of judicial intervention to prevent or remedy opportunistic misuse of the at-will dissolution mechanism by the majority group. In *Page*, two brothers entered into an oral agreement to jointly own and operate a linen supply business as a partnership.[77] Each partner contributed money capital.[78] One of the Page brothers (the defendant) served as managing partner and through a separate corporation supplied the linen and equipment necessary to the day-to-day operations of the partnership.[79] The other Page brother (the plaintiff) was not active in the business. After eight years of operation the partnership had lost approximately $62,000.[80] In year nine it made a small profit, and its prospects for future profitability looked bright because of the recent establishment of Vandenberg Air Force Base in the

NERSHIP 7:27-7:29 (1989)), such contractual power probably must be exercised in good faith. *See* Gelder Medical Group v. Webber, 363 N.E.2d 573 (N.Y. 1977). Failure to act in good faith would transform the expulsion into an event causing wrongful dissolution.

73 UNIF. PARTNERSHIP ACT § 38(1), 6 U.L.A. 456 (1969). The expelled partner must also be discharged from all partnership liabilities.

74 *Id.*

75 The pay-out-limiting provisions of such agreements may not be enforceable if, *ex post*, the sum due the expelled partner seems out of proportion to the damages actually experienced by the expelling partners. *See* Jones v. Chester, 363 S.W.2d 150, 156-57 (Tex. Ct. App. 1962). Such judicial aversion to liquidated damages provisions will increase the uncertainty costs in trying to draft an effective expulsion agreement. As to whether efficiency-minded courts should refuse to enforce such "liquidated damages provisions," see Goetz & Scott, *supra* note 30.

76 359 P.2d 41 (Cal. 1961).

77 *Id.* at 42.

78 *Id.*

79 *Id.* at 42, 44.

80 *Id.* at 42.

vicinity of the partnership's business.[81] Early in year ten, despite the prospect of future profits, the defendant apparently indicated his intent to dissolve the partnership. At that time, the partnership owed defendant's corporation $47,000, payable on demand.[82]

The defendant's goal in *Page* could be to "steal" a portion of the plaintiff's team-specific capital by purchasing the partnership's assets at a bargain price. The defendant would value the linen supply business assets more highly than outside bidders or the plaintiff because the defendant controls, through his corporation, equipment necessary and suitable to the operation of the team that would be costly to outsiders to reproduce, and because he possesses firm-specific human capital that would be costly for other bidders to replace. The defendant also has a bidding advantage over the plaintiff by virtue of the team-specific assets controlled by his corporation. That advantage might be increased by differences in the general wealth, and thus, bidding capacities of the plaintiff and defendant.[83]

On the other hand, defendant may simply be seeking to make an objectively justifiable adaptation to changed circumstances. The establishment of Vandenberg Air Force Base may have increased the value of the partnership's assets, but the defendant may have a more productive use of his share of the partnership's capital than allowing it to remain invested in the linen supply business.

Claiming to fear the consequence of dissolution, the plaintiff sought declaratory relief.[84] The trial court held that the partnership was for an implied durational term extending until partnership debts could be repaid, and, therefore, any premature dissolution would be wrongful.[85]

The Supreme Court of California reversed, finding that the plaintiff had "failed to prove any facts from which an agreement to continue the partnership for a term may be implied."[86] Additionally the court advised the parties about the fiduciary limits on the defendant partner's use of his dissolution power:

> A partner at will is not bound to remain in a partnership, regardless of whether the business is profitable or unprofitable. A partner may not, however, by use of adverse pressure 'freeze out' a co-partner and appropriate the business to his own use. A partner may not dissolve a partnership to gain the benefits of the business for himself, unless he fully compensates his co-partner for his share of the prospective business opportunity . . . .
>
> [P]laintiff has the power to dissolve the partnership by express notice to defendant. If, however, it is proved that plaintiff acted in bad faith and

81 *Id.* at 44.

82 *Id.*

83 In other words, the defendant is the stronger and, thus, the "majority" partner. *See supra* note 60.

84 *Page*, 359 P.2d at 43.

85 *Id.* at 42.

86 *Id.* at 43.

violated his fiduciary duties by attempting to appropriate to his own use the new prosperity of the partnership without adequate compensation to his copartner, the dissolution would be wrongful and the plaintiff would be liable as provided by [U.P.A. § 38(2)] for violation of the implied agreement not to exclude defendant wrongfully from the partnership business opportunity.[87]

Some commentators assert that *Page* unduly restricts the adaptability of majority partners.[88] These commentators argue that if the parties had wished to fetter the majority partner's withdrawal rights, they would have specified a durational term.[89] This view overlooks the longstanding role of fiduciary duty in partnership law[90] and the significance of the parties selection of partnership form instead of sole proprietorship form. Assuming rational actors, selection of general partnership form instead of sole proprietorship form signals to an efficiency-minded judge that the parties desired that more stringent judicial constraints be placed on the majority partner's adaptability than would be the case if the majority partner were the firm's sole proprietor.[91] Consistent with this expectation, *Page* recognizes that majority partners have substantially less adaptability than do sole proprietors.

A case that illustrates an appropriate judicial response to both minority shirking and opportunistic demands for alteration of partnership terms is *Drashner v. Sorenson.*[92] The plaintiff, Drashner and the two defendants formed an equal partnership to operate a real estate, loan, and insurance agency in Rapid City, South Dakota.[93] The business was profitable, but harmony short-lived. Within six months after commencement of the partnership, the partners were having bitter disagreements centering on Drashner's desire to change the partners' agreement that a substantial portion of partnership earnings be retained to cover operating expense rather than distributed to the partners for their personal use. The plaintiff sought a judicial decree of dissolution, and defendants coun-

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87 *Id.* at 44-45.

88 *See* Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 27-33 (1982); Jason S. Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291 (1992).

89 Hillman, *supra* note 88, at 33.

90 This role is often described by reference to Judge Cardozo's opinion in Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928), in which the court imposed restrictions on a joint venturer's right to profit from opportunities coming to fruition well after the expiration of the venture's specified term:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Id. at 546.

91 *See* O'Kelley, *supra* note 16.

92 63 N.W.2d 255 (S.D. 1954).

93 *Id.* at 256-57.

terclaimed seeking similar relief. The trial court found for the defendants, holding that Drashner's actions had caused a wrongful dissolution of the partnership, thereby giving defendants the normal rights granted to nonwrongfully acting partners.[94] The South Dakota Supreme Court affirmed, describing the facts supporting the trial court's determination as follows:

> The breach between the parties resulted from a continuing controversy over the right of plaintiff to withdraw sufficient money from the partnership to defray his living expenses . . . .
>
> As an outgrowth of this crucial difference, there was evidence from which a court could reasonably believe that plaintiff neglected the business and spent too much time in a nearby bar during business hours. At a time when plaintiff had overdrawn his partners and was also indebted to one of defendants for personal advances, he requested $100 and his request was refused. In substance he then said, according to the testimony of the defendant Deis, that he would see that he "gets some money to run on", and if they "didn't give it to him he was going to dissolve the partnership and see that he got it." Thereafter plaintiff pressed his claims through counsel, and eventually brought this action to dissolve the partnership. The claim so persistently asserted was contrary to the partnership agreement found by the court.[95]

The court in *Drashner* apparently succeeded in identifying minority opportunism. However, the line between legitimate policy disputes and ordinary negligence on one hand, and opportunistic minority action on the other, is murky at best. Majority partners situated like the defendants in *Drashner* may take the position that the minority partner's actions have caused a wrongful at-will dissolution and claim the right to continue the firm. But if a court disagrees and finds dissolution nonwrongful, then the majority will be forced to take on greater investment risk in purchasing the firm's assets at fair value and, then, buying out the minority's partnership interest. Accordingly, minority partners are likely to have substantial room for opportunism founded on majority aversion to taking on greater investment risk whenever a partnership has substantial team-specific, nonhuman capital value.[96]

Partnership form thus exposes majority partners to two risks: the risk that a minority partner will extort unfair changes in team rules by opportunistically threatening to dissolve the partnership and the risk that a minority partner will shirk, content in the belief that the majority will be unwilling to expel her for fear that a court might label the resulting dissolution wrongful.

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94 *See supra* notes 66-70 and accompanying text.

95 *Drashner*, 63 N.W.2d at 258-59.

96 Of course, the downside of *Page* is that its constraints on majority opportunism increase the room for minority opportunism.

IV. A Theory of Closely Held Corporate Form

A. *Corporation Law and the Archetypical Closely Held Corporation*

Jointly owned firms may be conceived of as occupying a continuum ranging from two-owner, closely held firms that could be organized almost as efficiently outside of a firm or as a sole proprietorship, to publicly held firms having thousands of shareholders and enormous amounts of human and money capital.[97] As explained in Part III, general partnership law provides an optimal governance structure for closely held firms located at the small end of this spectrum. As closely held firms move toward the publicly held end of the spectrum, general partnership-law governance rules become less optimal and at some point, corporate form becomes the value-maximizing choice.[98]

In an archetypical closely held corporation located near the margin where organization as a general partnership would be equally efficient, each shareholder will make significant team-specific investments. *Ex ante* each shareholder will expect that her employment with the firm will continue indefinitely and that she will share in the firm's profits ratably along with other shareholders. Moreover, each shareholder will expect that she will be able to withdraw her money capital investments from the firm under certain circumstances. However, each shareholder will attach greater value to the firm's adaptability to changed circumstances and to elimination of the risk of shirking or opportunistic use of withdrawal rights by a minority shareholder than to the value of guaranteeing a minority shareholder's right to continue as an employee, to share ratably in the firm's profits, or to withdraw money capital from the firm.

Consistent with the expectations of shareholders in an archetypical closely held corporation, corporation-law norms[99] make it substantially easier for a closely held firm to accomplish needed adaptations to the team's rules or make-up and expose the incorporated team to much less risk of minority opportunism than would be the case for a similarly situated firm operating under general partnership norms. Suppose, for example, that a closely held firm's needs evolve, or the skills of one of its

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97 *See supra* note 48 and accompanying text.

98 At this point, I am still ignoring the distorting effect of tax and limited liability rules. The spectrum I am describing locates firms only in terms of their internal governance needs. These needs are a function of the magnitude and distribution of team specific capital, the team's expected duration, and team members' wealth and risk characteristics. The distorting effect of tax or limited liability rules is discussed *infra* at Parts IV.B, IV.C.2(b), and IV.C.2(c).

99 Corporation law provides an off-the-rack governance structure for jointly owned, closely held firms, the key features of which are: (1) Separation of ownership function into three functional realms — shareholders, directors, and officers; (2) no dissolution at-will by minority investors; (3) investors have no guaranteed right to serve as corporate employees; (4) majority rule on all major decisions; (5) limited liability for shareholders; (6) free transferability of shares; and (7) minority shareholder expectations are afforded legal protection primarily by their ability to seek involuntary dissolution or relief founded on the majority's alleged breach of fiduciary duty.

joint owners erode, so that it becomes objectively justifiable from an *ex post* perspective to change such joint owner's duties or compensation or to discharge her from the firm's employ. The corporation's adaptive mechanism is the board of directors acting by majority rule. Such mechanism enables the majority to insist on a change in the duties or compensation of a minority owner without incurring significant costs. If the minority shareholder is unhappy with her new status she may withdraw her human capital from the team (if not already discharged) and sell her shares.[100] Alternatively, she may bring a petition for involuntary dissolution on the grounds that the majority's actions are oppressive or that equitable relief is necessary to protect the minority's reasonable expectations or interests.[101] Each of these protective devices is imperfect. If the minority shareholder sells her shares, she is likely to receive substantially less than she would if the corporation were dissolved and its assets sold as a going concern. If she seeks equitable relief, she must carry the burden of proving predicate facts entitling her to relief.

As the foregoing summary suggests, corporation law does not give majority shareholders absolute discretion. Nonetheless, corporation law is tilted in favor of the majority. In contrast, partnership-law norms allow the majority to make major adaptations without the minority's consent, but only by dissolving the partnership. Dissolution normally exposes the partnership's assets to judicial sale and gives the minority owner an option to force a repurchase of her partnership interest either via private negotiation or out of the proceeds of such sale.[102] Additionally, the majority's decision to dissolve carries with it the risk that the dissolution may be labeled wrongful and that the minority partner may be awarded control over the firm's assets. In other words, compared to corporation law, partnership law is tilted toward protection of the minority.[103]

The downsides of corporate statutory governance norms, especially when compared to partnership statutory governance rules, are the relative lack of assurance that individual adaptive needs will be satisfied and the relatively greater risk of majority opportunism posed because minority shareholder's may not withdraw their money capital from the firm. If a partner finds it value-maximizing to withdraw her capital from the firm and invest it elsewhere, the at-will dissolution mechanism insures that she will be able to do so. In a corporation, a minority shareholder has no similar adaptive rights.[104] On the other hand, the corporation law pref-

[100] Under corporate norms, shares are freely transferable. *See, e.g.*, DEL. CODE ANN. tit. 8, § 202 (1991); REV. MODEL BUSINESS CORP. ACT § 6.27 (1991).

[101] For a thorough review of the state of involuntary dissolution law, see Thompson, *supra* note 3.

[102] *See supra* note 55 and accompanying text.

[103] *See supra* notes 66-70 and accompanying text.

[104] This is, of course, a fatal defect in the view of Hetherington and Dooley. *See* Hetherington & Dooley, *supra* note 5, at 1-6, 34-50.

erence for majority adaptability combines with the lack of a unilateral minority withdrawal right to insulate the majority from the threat of minority opportunism. A minority shareholder simply has no ability to withdraw unilaterally, and thus, no ability to extort an objectively unjustifiable change in terms from the majority.

Under the foregoing analysis, the archetypical closely held corporation is functionally somewhat further from the marginal point at which ownership as a jointly owned firm or outside of a firm would be equally efficient than is an archetypical general partnership. The characteristics that place the archetypical closely held corporation further from this margin are the relatively greater expected value of its team-specific nonhuman capital, and the greater *ex ante* cost that its owners attach to possible minority opportunism. It can be hypothesized, then, that rational owners of a jointly owned firm select corporate form over partnership form, all other things being equal, when the expected gains from greater team adaptability and diminished risk of minority opportunism more than offset the expected losses from decreased individual ability to adapt and increased majority opportunism.[105]

B. The Nonarchetypical Closely Held Corporation

If internal governance needs were the sole basis for choosing organizational form and if all investors were rational and well-informed, then close corporations would come into existence only when corporate norms provided, *ex ante*, a better balance between opportunism and adaptability for a particular jointly owned firm than would be provided by alternative organizational forms. However, it is commonly believed that a large number of nonarchetypical close corporations are formed to take advantage of limited liability, even though corporation law governance norms are not optimal for such firms.[106]

We can assume that individuals rationally form nonarchetypical close corporations whenever they calculate *ex ante* that the value flowing from limited liability will exceed the costs resulting because corporate

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105 The failure to recognize the central function served by corporate law is true of commentators on partnership form as well. Consider this comment by Larry Ribstein:

> Because free transferability of partnership property rights is not feasible, dissolution at will provides an important escape route. But dissolution at will gives the dissolving partner the power to appropriate firm assets and inflict significant costs on the other partners. Thus, the U.P.A. escape route amounts to handing each partner a cache of dynamite.

Ribstein, *supra* note 55, at 360.

Ribstein tacitly assumes that partnership norms should be designed to accommodate rational joint owners of closely held teams with substantial team-specific value. In fact, that is the role of corporate law.

106 Limited liability allows risk-averse investors to diversify their investment portfolios at least to some extent. For an economic analysis of limited liability, see EASTERBROOK & FISCHEL, *supra* note 10, at 40-62; Susan Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTITUTIONAL & THEORETICAL ECON. 601 (1985).

form provides a less desirable governance structure than would some other business form. Further, we can hypothesize that nonarchetypical corporations are of two main types—*sole-proprietorship corporations* and *partnership corporations*. Sole-proprietorship corporations are corporations that would have been organized as unincorporated sole proprietorships except for the distorting effect of limited liability rules. Partnership corporations are corporations that would have been organized as general partnerships except for the same distorting effect.

C. Ex Ante *Contracting or* Ex Post *Gap-Filling in the Close Corporation Setting*

1. The Need for Ex Ante *Contracting or* Ex Post *Gap-Filling.*—The foregoing subparts of this Part explain why archetypical and nonarchetypical close corporations choose corporate form as a *starting* point, but they also suggest that such firms would find corporate norms less than perfect. The closer an archetypical close corporation is to the margin where organization as a general partnership would be equally efficient, the less clear-cut is the choice between partnership and corporate norms. For partnership corporations, the corporate norms are in fact less desirable than partnership norms. And for sole-proprietorship corporations, the preferred allocation of governance powers and risks would be that provided by sole proprietorship form.

There are two mechanisms by which the governance rules of closely held corporations can be made more optimal. First, the investors in such corporations can contractually modify the corporate rules to achieve an optimal set of governance rules for their particular corporation. Second, courts can modify the governance rules *ex post* via efficiency-minded use of their equitable powers.

2. Contractual Responses to Shortcomings in Close Corporation Governance Rules.—

(a) Introductory note.—Corporation statutes in all states now allow shareholders substantial freedom to modify the corporate adaptive rules by unanimous contractual agreement.[107] This contractual freedom may be used to tailor corporate form to achieve the desired balance of opportunism and adaptability. The foregoing analysis provides a basis for predicting what types of contracting devices will be value maximizing from an *ex ante* point of view. The remainder of this section summarizes those predictions.

[107] Such agreements may occur as provisions in the articles of incorporation or by-laws, or in separate written agreements. In some states such agreements can be accomplished with less transaction costs or less uncertainty if the shareholders elect to be covered by special close corporation default or enabling rules.

(b) Contractual modifications in partnership corporations.—Partnership corporations would choose general partnership form as a starting point except for the distorting effect of limited liability. For these firms, corporate form exposes minority investors to too great a risk of majority opportunism and provides them with too little adaptability. Accordingly, rational investors in partnership corporations may find it value enhancing to modify the corporate norms contractually. For example, involuntary transformation to passive status may be prevented by a shareholder agreement providing that each shareholder shall be continued as an employee and director and shall be entitled to receive an agreed share of corporate earnings until and unless otherwise unanimously agreed.[108] Likewise, the problem of investment illiquidity that restricts the ability of minority shareholders to adapt to changed circumstances can be eliminated by a shareholder agreement giving each shareholder a right to be bought out for fair value by either the corporation or nonwithdrawing shareholders.

Available evidence suggests that relatively few closely held corporations adopt such contractual devices.[109] This may be because there are relatively few partnership corporations. Alternatively, it may be that the cost of negotiating and executing these agreements is greater than the present value of the expected cost of having corporation governance norms instead of partnership governance norms. After all, if investors in a jointly owned firm prefer partnership governance rules, then the amount of expected team-specific money capital investment must be relatively small. Therefore, the discount in value from using corporation-law governance norms instead of partnership-law governance norms may also be small. It is also possible that contractual modifications are not more widely used because, while it is relatively easy to create minority shareholders' rights contractually, it is very difficult to do so in a way that replicates the balance between opportunism and adaptability achieved by partnership law. For example, the risk of minority opportunism presented by an unconditional contractual buy-out right may be *greater* than the risk posed by operating as an at-will partnership because

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108 The longstanding judicial unwillingness to enforce shareholders' agreements is derided by many commentators. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 10, at 235 (commenting on the famous shareholder agreement case, McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934)). However, the rule prohibiting complete sterilization of directors' discretion would be value-maximizing if all close corporations were archetypical. In such case, it could be presumed irrational to completely sterilize the directors' discretion because by definition archetypical corporations choose corporate form because they prefer majority adaptability over the risks of minority opportunism posed by forms or contracts that place primary emphasis on protecting the minority from majority opportunism. Perhaps the decline of the old rule prohibiting sterilization is traceable to the emergence of a new class of close corporations—the partnership corporation. For an interesting look at the evolution of state corporation law, see Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365 (1992).

109 *See* F. HODGE O'NEIL & ROBERT E. THOMPSON, O'NEAL'S CLOSE CORPORATIONS, § 1.18 (3d ed. 1990).

opportunistic withdrawal will not be subject to the constraining effects of the fiduciary duty and wrongful dissolution provisions of partnership law.[110]

(c) Contractual modifications in archetypical closely held corporations.—Archetypical close corporations located near the margin where partnership-law norms would be equally efficient might find it value-enhancing to make minor modifications to corporate form designed to increase the minority's adaptability and protection from majority opportunism while preserving the majority's discretion and protection from minority opportunism. On the other hand, the relatively small amount of team-specific capital at stake may not justify the costs and risks of error involved in *ex ante* contracting designed to fine tune the firm's governance rules.

For example, rational investors in a near-the-margin archetypical close corporation might find it value-maximizing to contractually provide for the repurchase of a minority shareholder's stock in the event of ordinary retirement or death. However, such firms would be unlikely to give minority shareholders an option to have her shares repurchased at anytime. Such an unconditional contractual buy-out right would create a serious risk of minority opportunism, the very risk that efficiency-minded owners of an archetypical closely held corporation seek to avoid by choosing corporate form.[111]

Likewise, investors in a near-the-margin closely held corporation would be unlikely to grant minority investors a contractually fixed right to continued employment and to a predetermined share of profits. Such rights would undermine the adaptability of the team and create a risk of minority opportunism in the form of shirking, two problems that efficiency-minded joint owners in an archetypical closely held corporation seek to avoid by choosing corporate form instead of partnership form.

(d) Contractual modifications in sole-proprietorship corporations.—Rational investors in sole-proprietorship corporations would choose sole proprietorship form except for the distorting effect of limited liability. So long as sole-proprietorship corporations have only one shareholder, the corporate governance norms are irrelevant. The sole shareholder controls the corporation, and the corporation as proprietor has the same

[110] Hetherington and Dooley apparently overlooked the variety of adaptive and opportunism-preventing purposes served by the partnership adaptive mechanism, as supplemented by informed judicial application of the wrongful dissolution mechanism. This may explain why they suggested that the problem of majority opportunism, or oppression, can be solved by providing minority shareholders with an immutable statutory right to have their shares repurchased by the corporation for fair value, regardless of fault, whenever it suits their individual interest. *See* Hetherington & Dooley, *supra* note 5, at 41-46.

[111] Easterbrook and Fischel make a similar argument but do not limit it to the archetypical corporation. EASTERBROOK & FISCHEL, *supra* note 10, at 238.

right to control and discharge at-will employees as would an unincorporated proprietor. However, the principal investor in a sole-proprietorship corporation may at some point transfer a minority share interest to one or more key employees as an incentive-alignment device.

Creating minority share interests will expose the majority shareholder to potential judicial second-guessing via fiduciary duty suits and petitions for involuntary dissolution pursued by disgruntled minority shareholders. Therefore, creating such interests may increase the expected cost of minority shareholder shirking[112] or opportunistic threats to withdraw from the firm. On the other hand, creating such minority share interests may create even greater expected gains from increased effort and loyalty by key employees who now have a proprietary stake in the corporation.

If the sole shareholder in a sole-proprietorship corporation wishes to create minority share interests without greatly increasing the risks from exposure to shareholder litigation, then *ex ante* contracting is in order. The indicated contract would confirm the corporation's right to discharge the employee at-will and would provide that the corporation may repurchase the minority's shares when the minority shareholder leaves the corporation's employ either voluntarily or involuntarily. To preserve incentive effects, but minimize the risk of opportunism, the share repurchase agreement should provide a purchase price formula that will penalize the minority shareholder who leaves the corporation's employ prematurely.[113]

3. Judicial Responses to Shortcomings in Close Corporation Governance Rules—A Theory of Efficiency-Minded Judging.—

(a) An overview.—The preceding Parts of this Article develop what might be called a Coasean theory of rational form selection.[114] Before entering into a prospective venture, rational investors engage in a com-

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112 Such risk would be increased to the extent that the majority shareholder would be more unwilling than a sole proprietor to take future adaptive steps—such as discharging the minority from the corporation's employ—for fear that the minority shareholder would prevail in a subsequent lawsuit or petition for involuntary dissolution.

113 Such agreements present problems for efficiency-minded courts only when the parties' intent is ambiguous. For example, suppose that a sole shareholder sells shares to a key employee subject to a share repurchase agreement that requires the employee to sell her shares back to the corporation at book value if she ceases to be an employee of the corporation before a specified date. If the value of the corporation's shares sharply increases before that date, what remedies if any should the disgruntled employee have—the rights of an at-will employee or the greater protection afforded by fiduciary duty? To what extent does the answer depend on the clarity of the parties contract? *See* Jordan v. Duff and Phelps, Inc., 815 F.2d 429 (7th Cir. 1987); Magic Woods, Inc. v. Chaplin, No. 64,054, 1990 Kan. App. LEXIS 508 (Kan. Ct. App. July 13, 1990); Pedro v. Pedro, 463 N.W.2d 285 (Minn. Ct. App. 1990); Gallagher v. Lambert, 549 N.E.2d 136 (N.Y. 1989); Ingle v. Glamore Motor Sales, 535 N.E.2d 1311 (N.Y. 1989).

114 *See* O'Kelley, *supra* note 16.

parative search for best investment.[115] If a cooperative endeavor is selected, then the prospective venturers must choose for that venture the organizational form that offers the optimal balance between adaptability to changed circumstances and risk of opportunism. Finally, the venturers must decide whether contractual modifications to the state-provided rules of the chosen form will be value enhancing.

The Coasean theory of rational form selection explains the role played by efficiency-minded judges when resolving a dispute between minority and majority shareholders in a closely held corporation. If the parties are presumed to have chosen corporate form rationally and for governance reasons, then the efficiency-minded judge will resolve the particular dispute in a manner consistent with the level of majority discretion normally afforded by corporate form. In other words, the court will assume that these rational investors wished the majority to have greater adaptability and freedom from minority opportunism than would have been afforded by partnership form, but less adaptability and freedom from minority opportunism than would have been provided if the venture had been organized as an unincorporated sole proprietorship.

Understanding the Coasean theory of rational form selection allows efficiency-minded judges to provide litigants with what rational investors "would have wanted"—the mix of opportunism and adaptability common to the business form they selected. However, this Coasean theory does not enable judges to determine whether a particular complaining minority shareholder should prevail. Rather, it enables judges to determine that such litigant must be asked to carry a burden of proof and persuasion that is consistent with the mix of opportunism and adaptability provided by corporate form.

The theory of efficiency-minded judging just traced assumes that investors both choose organizational form rationally and that the state provides a sufficient number of standard forms from which prospective investors may choose. But what if the state provides insufficient forms or if investors do not choose organizational form rationally?[116]

As discussed above, investors in partnership corporations, sole-proprietorship corporations, and in near-the-margin archetypical closely held corporations would find it value enhancing from an *ex ante* point of view if they could costlessly replace the governance norms provided by

[115] That investment which offers the most attractive return on invested human and money capital given the investor's taste for risk.

[116] Consistent with the view that partnership corporations exist when investors choose corporate form because of the distorting effect of limited liability, it could be argued that states should provide a business form that provides both limited liability and partnership-like internal governance rules. The Limited Liability Company appears to be such a business form. Legislation authorizing limited liability companies was enacted by Wyoming in 1977, by Florida in 1982, and by twelve other states in 1991-1992. Once this form is generally available the number of partnership corporations should diminish.

corporate form with more suitable rules. However, there are at least three possible reasons why investors in these firms would not contract for the "perfect" governance structure. First, contracting is not costless, and the costs of contracting might exceed the predicted benefits. Second, actual investors may not be fully rational, resulting in mistaken failure to contract. Third, rational investors might predict that courts will exercise their equitable gap-filling powers to provide optimal governance rules to the parties *ex post*, thereby making *ex ante* contracting unnecessary.

The foregoing analysis suggests that in a large number of close corporation cases the court must face the possibility that the shareholders did not modify corporate form to achieve the mix of opportunism and adaptability which rational investors would have viewed as ideal from an *ex ante* perspective. An efficiency-minded court responds to this possibility by deciding whether the cost to society of applying a rule which similarly situated rational investors might not have selected exceeds the costs of attempting to provide the governance structure which rational shareholders presumably would have selected.[117]

There are two potential costs of *ex post* judicial contracting. First, if courts contract for the parties this will create disincentives for the parties themselves to identify via contract the mix between opportunism and adaptability that they prefer. A court should create this disincentive only if it is likely that the court will be able to determine *ex post* better than the parties themselves could *ex ante* which governance structure is "ideal." The court's answer to this may depend on how likely it seems that investors in closely held corporations will be prevented from reaching the "ideal" governance structure by either rationality defects or the costs of contracting.

Second, the court must consider how likely it is that it will make a mistake. For example, how likely is it that the court will apply partnership law rules to a closely held corporation when similarly situated rational investors would not make that selection? The possibility of such judicial errors will result in a devaluation of close corporation form. In other words, the possibility that courts will wrongly guess that the investors did not prefer corporation governance norms will decrease the value of future investments in archetypical corporations because investors will be less able to depend on the freedom from minority opportunism and majority adaptability which they desire.

(b) An illustrative case.—

(i) An introductory note.—Courts and commentators often misuse the partnership analogy and "would have wanted" gap-filling

117 Notice that this is very different from saying that efficiency-minded courts should provide the precise substantive result to a particular dispute that rational parties would have selected *ex ante*. That is beyond the pale. However, it is reasonable to attempt to provide the "perfect" governance structure.

formula. Justice Tauro's opinion in *Donahue v. Rodd Electrotype Co.*[118] and Frank Easterbrook and Daniel Fischel's criticism of the substantive decision in that case[119] provide examples of both types of misuse. Thus, *Donahue* provides an opportunity to illustrate the theory of rational form selection and efficiency-minded judging traced above.

(ii) Donahue v. Rodd Electrotype Co.—Henry Rodd and Joseph Donahue joined the employ of Rodd Electrotype Company, then operating under another name, in 1935 and 1936, respectively. Rodd specialized in general management. Donahue specialized in the manufacturing end of the business.

When Rodd and Donahue joined Rodd Electrotype it was a wholly owned subsidiary of the Royal Electrotype Company ("Royal").[120] Over the years, Royal made some of its shares available to Rodd, Donahue, and Lawrence W. Kelley. By 1955, Rodd had acquired 200 shares, Kelley 25 shares, and Donahue had purchased 50 shares "at the suggestion of Harry Rodd, who hoped to interest Donahue in the business."[121] Royal retained 725 of the 1000 outstanding shares.[122]

In June of 1955, Rodd and Donahue became the sole shareholders of Rodd Electrotype.[123] Control was obtained by having Rodd Electrotype repurchase the 725 shares owned by Royal and the 25 shares owned by Kelley. In these repurchases Rodd Electrotype immediately expended $76,000 in cash and executed notes to Royal in the total amount of $60,000.[124] Most of the cash used by Rodd Electrotype was loaned to it by Harry Rodd, who mortgaged his house to obtain some of the needed funds. The purchase money notes were paid off by Rodd Electrotype over the period from 1955 to 1960.[125] As a result of these transactions, Rodd owned 200, and Donahue 50, of the 250 outstanding shares of Rodd Electrotype.[126]

From June, 1955 until 1970, the composition and nature of the underlying team "owned" by Rodd Electrotype continued to evolve and adapt to changed circumstances. Gradually, the roles of Rodd and Donahue in the firm decreased. Charles Rodd became corporate vice president in 1962, a director in 1963, and succeeded his father as president and general manager in 1965.[127] In 1964, Frederick Rodd, another of

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118 328 N.E.2d 505 (Mass. 1975).

119 EASTERBROOK & FISCHEL, *supra* note 10, at 245-48.

120 *Donahue*, 328 N.E.2d at 505.

121 *Id.* at 509.

122 *Id.*

123 *Id.*

124 *Id.*

125 *Id.*

126 *Id.*

127 *Id.*

Harry's sons, replaced Donahue as plant superintendent.[128] During this period, Harry Rodd gave 119 of his shares in Rodd Electrotype to his two sons and a daughter, Phyllis Mason.[129] These changes apparently occurred harmoniously.

In the period from May 1970 to April 1971, any remaining harmony in the relation between Donahue and the posttransformation firm was shattered. During that period Harry Rodd liquidated his remaining shares in the corporation. He gave 30 shares to his children, 45 shares were acquired by Rodd Electrotype for $800 per share, and the remaining 6 shares were acquired by his children, also for $800 per share.[130] When Donahue then requested that Rodd Electrotype purchase his 50 shares, the corporation refused.[131] Subsequently, Donahue sued challenging the corporate repurchase of Harry Rodd's shares and seeking equitable relief. The trial court dismissed the petition on the merits, and the appeals court affirmed.[132]

Justice Tauro, speaking for the Supreme Judicial Court of Massachusetts, analyzed these facts by reference to the following partnership analogy:

> [W]e deem a close corporation to be typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation. As thus defined, the close corporation bears striking resemblance to a partnership . . . . In a partnership, a partner who feels abused by his fellow partners may cause dissolution by his "express will . . . at any time" . . . and recover his share of partnership assets and accumulated profits . . . . The minority stockholder, by definition lacking fifty per cent of the corporate shares, can never "authorize" the corporation to file a petition for dissolution . . . . Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties . . . . Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.[133]

Justice Tauro concluded that in the context of a closely held corporation's repurchase of shares from a controlling shareholder, the majority's fiduciary duty could only be satisfied by allowing the minority to

128 *Id.*
129 *Id.* at 510.
130 *Id.*
131 *Id.* at 511.
132 *Id.* at 508.
133 *Id.* at 514-15.

participate in the repurchase on the same terms as the majority.[134]

(iii) Easterbrook and Fischel's Analysis.—Frank Easterbrook and Daniel Fischel believe that efficiency-minded judges would not have granted relief to Donahue. Their arguments are based on their version of the "would have wanted" gap-filling rule.

> If a court is unavoidably entwined in a dispute, it must decide what the parties would have bargained for had they written a completely contingent contract. The difficulties that result when a court misses this point are illustrated by the much applauded case of *Donahue v. Rodd Electrotype Co.*
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> . . . .
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> Grave reflections on the plight of minority investors in closely held corporations and stirring proclamations of the fiduciary duty of the majority fill the opinion. Completely overlooked in all of this rhetoric was the basic question—which outcome would the parties have selected had they contracted in anticipation of this contingency? Although no one can answer such a question with certainty (precisely because the parties did not), it is most unlikely that they would have selected a rule requiring an equal opportunity for all. Buyouts facilitate the retirement of a manager who, by virtue of advancing age and poor health, no longer contributes . . . . Buy-sell agreements provide some liquidity and ensure that the identity of the managers and the investors remains the same, reducing agency problems. At the same time, the limited scope of the obligation reduces the cost of cash payouts . . . . No comparable commonly used agreement requires a firm to purchase all shares if it buys any.[135]

(iv) Rational form selection and efficiency-minded judging in Donahue v. Rodd Electrotype Co.—Under the theory developed in this Article, *Donahue* is a relatively easy case. An efficiency-minded judge must first determine whether at the outset of the incorporated venture rational investors in Donahue's and Rodd's shoes would have preferred sole proprietorship or general partnership internal governance norms to the norms of corporation law.

Rodd Electrotype Co. was clearly not a partnership corporation when Rodd and Donahue became its sole owners in 1955. Rodd had mortgaged his house to consummate his stock purchase, which indicates both that the corporation's value was dependent on firm-specific assets viewed by outside lenders as risky collateral and that Rodd had tied up most of his personal wealth in this transaction. Accordingly, a rational Rodd would have been unwilling to invest in this venture if subjected to the risk of minority opportunism presented by general partnership law and its at-will withdrawal mechanism.

Nor should Rodd Electrotype Co. be described as a sole-proprietorship corporation. The same facts that show why a rational Rodd would

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134 *Id.* at 518.

135 EASTERBROOK & FISCHEL, *supra* note 10, at 245-46.

not agree to general partnership norms *ex ante* also show that a rational Donahue would not have agreed to invest if Rodd insisted on having the same discretion over his invested capital as would a sole proprietor. If Rodd merely allowed Donahue to continue as a shareholder as an incentive-compensation device, then sole-proprietorship characterization would be plausible. However, Rodd would not likely have viewed Donahue's stock retention as merely an incentive-compensation device. A rational, risk-averse Rodd would not have wanted to put any more of his personal wealth at risk than was already necessary to finance his own stock purchases. Accordingly, a rational Rodd would have viewed Donahue as a co-investor, and would have realized that Donahue would not agree to continue his investment if Rodd insisted on sole-proprietor-like freedom from fiduciary duty.

Justice Tauro's mistake was in characterizing an archetypical corporation as a partnership corporation. While under some circumstances it might be value-enhancing for courts to apply partnership-like rules to partnership corporations, it would never be efficient to apply such rules to archetypical close corporations. Thus, Justice Tauro's decision was unsustainably overbroad. Under Tauro's version of the partnership analogy, investors in any close corporation are viewed as having the same governance needs as investors in an archetypical general partnership. Logically, then, any majority shareholder decision that gave minority shareholders something other than their rights as quasi-partners would be suspect. As a result, minority shareholders would have substantial room to threaten suit opportunistically, undercutting one of the principal governance reasons for choosing corporate form. Recognizing this defect, the court quickly backed away from the implications of its overbroad rationale.[136]

Easterbrook and Fischel's analysis also suggests that the *Donahue* court reached the wrong result—that is a different outcome than the parties themselves would have wanted had they been able to costlessly bargain at the outset. Their misuse of the "would have wanted" formula, like Tauro's misuse of the partnership analogy, seems rooted in the belief that all closely held corporations have similar governance needs.[137] If this is accepted as true, then an efficiency-minded court can observe how these larger close corporations solve particular problems and supply the same solutions to small close corporations who cannot afford the cost of

136 In Wilkes v. Springside Nursing Home, 353 N.E.2d 657 (Mass. 1976), the Supreme Judicial Court backed away from the implications of *Donahue* and recognized that "[t]he majority concededly have certain rights to what has been termed 'selfish ownership' in the corporation which should be balanced against the concept of their fiduciary obligation to the minority." *Id.* at 663. The court then stated that the majority must prevail if it can show a legitimate business purpose for its actions unless the minority can show that such purpose could have been served by means less injurious to the minority. *Id.*

137 EASTERBROOK & FISCHEL, *supra* note 10, at 252.

providing such solutions for themselves via *ex ante* contracting. Conversely, if these larger corporations do not choose to provide rules for certain situations, then an efficiency-minded court should not provide such rules for smaller close corporations either. Under this corollary rule, Easterbrook and Fischel view the decision in *Donahue* as almost certainly wrong because it is not common for close corporation buy-sell agreements to require a firm to purchase the minority's shares if it decides to buy the majority's.

The theory of rational form selection outlined above suggests that Easterbrook and Fischel are wrong in assuming that larger and smaller close corporations have similar internal governance needs. Rational investors in partnership corporations and sole-proprietorship corporations would not choose corporate form but for the distorting effect of limited liability. Rational investors in close-to-the margin archetypical corporations would have much less fear of minority opportunism than would investors in larger close corporations where the magnitude of team-specific investment would make dissolution-at-will or similar buyout rules unthinkable. Accordingly, the failure of larger firms to contract for an equal opportunity rule does not suggest that such a rule would not be efficient for partnership corporations and sole-proprietorship corporations. Nor does it necessarily suggest that an equal opportunity rule would be inefficient for near-the-margin archetypical corporations, at least if the rule were limited to purchases after the death or retirement of the founding shareholders.

Easterbrook and Fischel's second error is the use of the "would have wanted" formula to predict the correct outcome in particular cases. The theory of efficiency-minded judging outlined above suggests a more modest goal. Efficiency-minded judges provide the result investors would have wanted when they are sensitive to the signalling effect provided by initial form selection. Rational investors understand, in general, the adaptive characteristics and opportunistic risks that normally attend corporate, partnership, and sole proprietorship form. They adopt a particular form in the expectation that should unresolvable disputes arise, courts will provide outcomes that are consistent with the investors' *ex ante* governance expectations. Accordingly, efficiency-minded courts will provide minority shareholder in archetypical close corporations with the level of equitable protection common to close corporation form.[138]

Under this theory, an efficiency-minded court must require the complaining shareholder to carry at least some burden of proof and persuasion. The goal is to provide the majority with less discretion than they would have as sole proprietors, but more discretion than they would have as general partners. This leaves the court with a large range of possible proper outcomes. In some cases, a court-ordered buy out might be ap-

[138] *See* O'Kelley, *supra* note 16.

propriate. In others, the minority should be denied relief. However, the outcome in a particular case should be criticized only if it will result in inefficient governance rules for archetypical corporations. In other words, a particular decision should be criticized only if it will give majority shareholders in archetypical close corporations as much discretion as a sole proprietorship or as little discretion as a general partner.

V. Conclusion

Reasoning by analogy has always been central to legal argument. This Article suggests that the contract and partnership analogies, properly understood, explain persisting puzzles relating to the close corporation. For example, an understanding of how differences in the extent and nature of team-specific investment effect the governance needs of jointly owned firms, suggests that jointly owned firms occupy a spectrum. At the simpler end are firms that are functionally close to the margin where organization outside of firm would be equally efficient. At the other, more complex , end are large, publicly held firms.

This Article suggests that, counter to the assertions of many commentators, there is an identifiable class of jointly owned, closely held firms—archetypical close corporations—for which unmodified corporate form is the preferred contractual starting point. This Article also identifies two other classes of corporations—the partnership corporation and the sole-proprietorship corporation—for which corporation norms would not be ideal.

The Article also suggests that critics of the contract and partnership analogies are justified in expecting more from proponents of these analogies. The governance needs of joint owners in closely held firms cannot be captured in a one sentence analogy or rule of decision. Instead, these analogies must be applied rigorously, with a much fuller explanation of the *ex ante* value effects at stake. The successful development of these analogies, then, will require that the teachings of transaction cost economics and the implications of relational contract theory be more systematically considered and applied. The theory of rational form selection and efficiency-minded judging sketched in this Article is but a small step in that direction.